Item 1

REPORT ON THE TAXATION OF LIFE INSURANCE COMPANIES

BY THE

SUBCOMMITTEE ON INTERNAL REVENUE TAXATION

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

DECEMBER 31, 1958

The printing of this subcommittee report has been authorized by the Committee on Ways and Means in accordance with its rules of procedure so as to make it available for informational purposes only. Its contents have not been substantively considered by the full committee or any member thereof and hence it has neither been approved nor disapproved by the full committee

UNITED STATES
GOVERNMENT PRINTING OFFICE
WASHINGTON : 1959

35207

COMMITTEE ON WAYS AND MEANS

WILBUR D. MILLS, Arkansas, *Chairman*

NOBLE J. GREGORY, Kentucky
AIME J. FORAND, Rhode Island
HERMAN P. EBERHARTER, Pennsylvania [1]
CECIL R. KING, California
THOMAS J. O'BRIEN, Illinois
HALE BOGGS, Louisiana
EUGENE J. KEOGH, New York
BURR P. HARRISON, Virginia
FRANK M. KARSTEN, Missouri
A. S. HERLONG, Jr., Florida
EUGENE J. McCARTHY, Minnesota
FRANK IKARD, Texas
THADDEUS M. MACHROWICZ, Michigan
JAMES B. FRAZIER, Jr., Tennessee

DANIEL A. REED, New York
THOMAS A. JENKINS, Ohio
RICHARD M. SIMPSON, Pennsylvania
ROBERT W. KEAN, New Jersey
NOAH M. MASON, Illinois
HAL HOLMES, Washington
JOHN W. BYRNES, Wisconsin
ANTONI N. SADLAK, Connecticut
HOWARD H. BAKER, Tennessee
THOMAS B. CURTIS, Missouri

Leo H. Irwin, *Clerk*
John M. Martin, Jr., *Assistant Clerk*
Thomas A. Martin, *Minority Adviser*
Gerard M. Brannon, *Professional Staff*

Subcommittee on Internal Revenue Taxation

WILBUR D. MILLS, Arkansas, *Chairman*

NOBLE J. GREGORY, Kentucky
THOMAS J. O'BRIEN, Illinois
FRANK IKARD, Texas

RICHARD M. SIMPSON, Pennsylvania
ROBERT W. KEAN, New Jersey
HOWARD H. BAKER, Tennessee

[1] Died September 9, 1958.

REPORT ON THE TAXATION OF LIFE INSURANCE COMPANIES

I. METHODS OF TAXING LIFE INSURANCE COMPANIES EMPLOYED IN THE PAST

The taxation of life insurance companies almost from the initiation of the income tax has presented difficult problems in determining an equitable tax base. The methods of taxing life insurance companies in fact has changed with considerable frequency since the adoption of the income tax in 1913.

Before 1921, life insurance companies in general were taxed under the regular provisions of the income tax laws applicable to ordinary corporations. This was quite similar to what now is referred to as the "total income" approach. From 1921 through 1957, life insurance companies have been taxed only with respect to investment income (generally rents, dividends, and interest). Within this broad category, however, quite different methods have been employed since 1921. From 1921 to 1941 an individual company-by-company approach was followed. Each company was taxed on its net investment income minus a specified percentage of its own required insurance reserves for policyholders. This has been referred to as taxing a company on its free investment income. From 1921 to 1931 companies were allowed a deduction equal to 4 percent of their own reserves and from 1932 to 1941 a deduction equal to 3¾ percent of these reserves.

In 1942 this company-by-company method of determining the portion of a company's free investment income was dropped and an overall, or industrywide, method of determining free investment income was substituted. From 1942 to 1948 the portion of net investment income allowed as a deduction was computed by the Secretary of the Treasury for the entire industry, based in part (65 percent) on the prior years' average reserve requirements and in part (35 percent) on the assumption that an investment income rate of return equal to 3¼ percent was required on total industry reserves. Once the Secretary computed such a reserve deduction for the entire industry, he expressed this deduction as a percentage of the investment income of the entire industry for the prior year, and each company then applied this percentage to its own net investment income for the current year. For 1949 and 1950 one modification was made in this method of taxing life insurance companies: the deduction computed by the Secretary was based entirely (instead of only to the extent of 65 percent) on the prior year's average reserve requirements of the industry.[1]

[1] In addition, under the 1950 formula companies having smaller net investment incomes than their reserve requirements were eliminated from the group from which the Secretary determined the ratio.

For the years 1951 through 1957 Congress in effect continued to tax the life insurance industry on a uniform percentage of net investment income, but no longer based this upon a determination by the Secretary of the Treasury as to industrywide reserve requirements. Instead, from 1951 through 1954 life insurance companies were in effect permitted to deduct 87½ percent of their investment income and required to pay tax at the regular corporate rate on the remaining 12½ percent.[2] For the years 1955 through 1957 also, life insurance companies were allowed to deduct a specified percentage of their net investment income. For this period the deduction was 87½ percent of the first $1 million of net investment income and 85 percent of any remaining income. However, the 1955–57 law also made several changes in the base on which the life insurance companies are taxed, including broadening the definition of net investment income, taxing the income of life insurance companies from accident and health and other nonlife operations in substantially the same manner as income of a mutual casualty insurance company, and providing a maximum tax for small new companies based upon the overall income as reported to State insurance commissioners.

The laws enacted since 1949, however, have been of a temporary or stopgap nature, with the result that, in the absence of any legislation to the contrary, the 1942 formula (but with modifications in the manner of computing investment income, etc., provided in the 1955 law) is applicable for 1958 and subsequent years.

Table 1 shows the percentages of net investment income deductible in computing taxable income under the various laws applicable to the years from 1942 through 1957. Of the four formulas used in this period, two, the 1942 formula and the 1950 formula, result in varying percentage deductions for different years. Table 2 shows the percentages which would have been applicable under these two formulas had they been applicable throughout the period 1942–57.

TABLE 1.—*Percentages of net investment income of life insurance companies deductible in computing taxable income, 1942–57*

Calendar year	Formula applicable	Percent of net investment income deductible	Calendar year	Formula applicable	Percent of net investment income deductible
1942	1942	93.00	1950	1950 stopgap	90.63
1943	1942	91.98	1951	1951 stopgap	87.50
1944	1942	92.61	1952	do	87.50
1945	1942	95.39	1953	do	87.50
1946	1942	95.95	1954	do	87.50
1947	1942	[1] 100.66	1955	1955 stopgap	[2] [illegible].5–85
1948	1942	[1] 102.43	1956	do	[2] 87.5–85
1949	1950 stopgap	93.55	1957	do	[2] 87.5–85

[1] No tax was paid in these years.
[2] 87.5 percent is deductible on the first $1,000,000 of net investment income and 85 percent on any remaining investment income.

[2] Actually, the tax for the years 1951 through 1954 was stated as 6½ percent of each company's net investment income (3¾ percent of the first $200,000). However, this is mathematically the same as a tax at the rate of 52 percent (30 percent on the first $25,000) on net investment income after deducting 87½ percent of this income.

TABLE 2.—*Percentages of net investment income of life insurance companies which would have been deductible under the "1942 formula" and "1950 formula," 1942–57*

Calendar year	1942 formula	1950 formula	Calendar year	1942 formula	1950 formula
	Percent	*Percent*		*Percent*	*Percent*
1942	93.00	(1)	1951	93.89	87.76
1943	91.98	2 91.12	1952	91.81	85.43
1944	92.61	2 91.13	1953	87.98	81.67
1945	95.39	2 93.22	1954	85.00	78.58
1946	95.95	2 93.15	1955	82.38	76.00
1947	100.66	2 96.52	1956	80.28	73.84
1948	102.43	2 97.55	1957	77.66	70.69
1949	100.83	2 93.55	1958	75.53	68.54
1950	96.72	90.63			

1 Not available.
2 These figures are approximations only.

II. PROBLEMS ARISING IN CONNECTION WITH THE TAXATION OF LIFE INSURANCE COMPANIES

In part problems have arisen in the taxation of life insurance companies from disagreement as to what constituted a proper investment income-tax base. This in fact was the consideration which has caused the shift in the methods of calculating free investment income under the various formulas which have been employed since 1942. Moreover, a dissatisfaction with the free investment income base reached under the 1955 stopgap formula is an important factor in accounting for the subcommittee's current consideration of the tax treatment of life insurance companies. However, this is not the only concern at this time. The point was made during the course of the subcommittee hearings in November 1958 that imposing a tax only on free net investment income misses entirely an important segment of the profits of many life insurance companies, or at least omits funds which companies treat like profits, since they retain them in surplus and subsequently, in some cases, pay them out as dividends to stockholders. The profits or funds referred to are gains from mortality savings and gains from overcharges in connection with the costs of selling and servicing policies. However, the point was also made during the hearings that any attempt to tax all of these gains on an annual basis without adjustment would raise serious competitive problems between mutual and stock life insurance companies, because of the way in which funds are returned to policyholders in the case of participating policies. The problems of taxing life insurance companies are discussed below under two headings: "Problems In Developing An Investment Income Tax Base" and "Problems In Developing a Total Income Base."

A. Problems in developing an investment income base

The free investment income approach in general holds that a life insurance company has income which is properly subject to tax at the company level only to the extent that investment income (after payment of investment expenses) is not needed in a reserve to pay future claims of policyholders and beneficiaries. Thus the problems in developing a free investment income base are primarily concerned with the determination of the policy and other contract liability deduction, or in general terms the deduction allowed for additions of interest to the reserves.

Various methods have been used, or suggested, as devices for measuring the appropriate size of the reserve deduction. Probably the most obvious would be to permit each company to deduct its own additions to reserves. This has not been used in any of the formulas which have been applicable in the past presumably because the proportion of the reserves which are built up through the use of investment income (as distinct from the proportion built up through premiums) is, in part at least, a matter within the control of the individual insurance company. Thus, it is stated that to permit an insurance company to deduct its own additions to reserves based upon its own assumed interest rate would in effect let such a company to a large extent determine its own tax liability. Moreover, it has been suggested that this would encourage companies to follow the policy of allocating a large proportion of their investment income to these reserves, with the result that they might be charging less than a safe margin of premiums.

The closest Congress has come to taxing insurance companies on the basis of each company's own addition to reserves was in the period from 1921 to 1942 when the companies were allowed a deduction equal to a specific percentage of their own reserves (4 percent from 1921 to 1931 and 3¾ percent from 1932 to 1941). While the use of a specified percentage applied to a company's own reserves in determining the policy and other contract liability deduction reduced somewhat the extent to which companies could determine their own tax, this element was still present since the specified percentage was applied individually to each company's reserves. Thus, the deduction varied from company to company, depending on the size of the reserve to which the percentage was applied.

It apparently was to avoid this differentiation among companies on the basis of whether they followed liberal or conservative methods in establishing their reserves that Congress in 1942 shifted over to an industrywide basis for determining the appropriate reserve and other contract liability deduction.

For the period 1942 through 1948 what in effect were two different methods of determining the appropriate size of the reserve deduction for the entire industry were used and then combined into a single industrywide ratio. One method of computing the industrywide reserve deduction was to determine the average deduction for the entire industry in each prior year. For the 2 years 1949 and 1950, with certain minor adjustments, this was in fact the only method used in computing the ratio. The second element in the 1942 formula applied to total industry reserves of the prior year an assumed interest rate of 3¼ percent. This deduction, weighted 35 percent, together with the industrywide prior year's experience deduction weighted 65 percent, then was expressed as a percentage of industrywide investment income for the prior year. The percentage so derived was then applied to the individual investment income of each company to determine its individual reserve deduction.

Both the combination formula used from 1942 to 1948, inclusive, and the formula used in 1949 and 1950 which depended solely on prior year's experience, were industrywide formulas. Thus, both avoided the difficulty of treating companies with conservatively financed reserves more harshly than companies with more liberally financed reserves, the problem implicit in any attempt to allow individual

companies to use their own additions to reserves. However, it has been suggested to your subcommittee that both of these industry-wide formulas present problems in that the policy reserve deduction obtained under them does not vary with the individual needs of the company, but only as their investment income increases or decreases. Thus, under both of these formulas it is argued that the policy reserve deductions, expressed on an industrywide basis, bear no relationship to the real reserve requirements of individual companies.

The 35 percent portion of the 1942 formula which was based upon an assumed investment rate of return of 3¼ percent presented another problem. Since industrywide reserve requirements actually were based upon a rate of return below this, as actual rates of return shrunk this, taken in combination with the prior year's earning experience, resulted in a ratio for 1947, 1948, and 1949 (although the latter was not applied) in excess of 100 percent of net investment income received. Thus, under the 1942 formula no part of a life insurance company's investment income was, or would have been, subject to tax during these years. This absence of any tax with respect to life insurance companies in these years highlighted the difficulties with the 1942 formula. However, as already indicated, even apart from this aspect of that formula it could be considered inadequate in that it did not recognize varying needs of individual companies.

As a result of further study of the tax treatment of life insurance companies, in 1951 still another technique of computing the reserve deduction was adopted. In effect, this same method, although with varying percentages, was followed from the year 1951 through the year 1957. Under this formula all life insurance companies were assumed to need a specified percentage of their net investment income to meet policyholder reserve requirements. From 1951 through 1954 this was assumed to be a flat 87½ percent. For 1955 through 1957 the percentage applied varied with the amount of net investment income, being 87½ percent on the first million dollars of such income and 85 percent on the balance. It has been indicated that such formulas continued the basic problem of the 1942 and 1950 formulas since they also were on an industrywide basis, and thus ignored the needs of individual companies. In addition, it has been pointed out that such formulas ignored the fact that from year to year actual earnings varied from the assumed rate on which the reserves were established and, therefore, that from year to year varying percentages of net investment income were needed by life insurance companies, even on an industry-wide basis, to meet reserve requirements.

The experience with varying formulas for determining reserve requirements has suggested to many that an individual company basis for determining needs is desirable, but only if some method is determined which for tax purposes does not vary additions to reserves, depending upon whether a company has established its reserves on a liberal or conservative basis. One formula suggested during the hearings—which has been referred to as the "Menge" formula—was designed to attain this result. This formula would base the reserve deduction on an individual company basis, but instead of using each company's assumed rate of earnings applied to its reserves, would use the company's actual rate of earnings applied to the reserves which a company would have established (usually smaller than its actual

reserves) had its reserves been built on the basis of the current actual earnings rate.

Such a formula, it is argued, avoids the problem of varying assumed earnings rates which may be employed by different companies. Since it is a company-by-company approach it also is stated to avoid the problems raised with respect to an industrywide formula which neglects individual company variations in need. One difficulty suggested with such a formula, however, is that, to some degree at least, it permits a company's reserve deduction to vary depending upon whether or not the company is able to obtain a high rate of return on investments. Thus, it is pointed out that under this formula those which are able to obtain a high rate of earnings on their assets would receive more generous deductions than others whose earnings rate is less. Because of this problem it is argued that some combination of assumed rates on reserves and actual earnings rates would be more appropriate. The Treasury suggestion, which is incorporated in a draft print described subsequently in this report, provides a deduction rate half way between the actual earnings rate of the individual company and an assumed rate of interest on the reserve. The assumed rate in this case is either the average for the industry in the prior year or the rate assumed by the individual company in establishing its own reserves, whichever is higher. It has been suggested that using the industry average in this case where the assumed rate of an individual company is relatively low avoids penalizing those who finance their reserves on a conservative basis.

B. Problems in developing a total income base

During the subcommittee hearings it was suggested that any method of taxing life insurance companies which depended solely upon taxing a portion of investment income would miss a significant segment of income realized by many life insurance companies. The income referred to is underwriting income. It is derived from premium charges which are in excess of the charges required to meet the claims of policyholders and their beneficiaries. Larger premiums than required for this purpose may be charged because of several factors. First, larger premiums than are necessary to meet claims may be charged because the insured persons live longer than assumed under the mortality tables used in estimating the necessary premiums. Secondly, premiums may be larger than necessary to meet claims because the so-called loading charges, or expenses of "putting the policy on the books" and servicing the policies once they are written, are smaller than anticipated. In addition, premiums may also include amounts over and above that calculated as necessary to pay claims.

These premium charges in excess of amounts ultimately required to meet claims, or underwriting income, can be held in surplus, paid out to stockholders, or paid out to policyholders. While in the latter case this can be viewed as merely a return of overcharges to the policyholder, it has been suggested this is not the case where the underwriting income is held in surplus, or where it is paid out to stockholders as dividends. It is contended that where such amounts are paid out to stockholders, there has been a payment made by the policyholder from which the stockholder derived a benefit and which therefore is properly classified as income. During the period the underwriting income is held in surplus, it is claimed that this income is substantially equivalent in effect to surplus derived through retained earnings.

In view of the considerations expressed above, many believe that in any satisfactory tax base for life insurance companies allowance must be made for underwriting profits. This was the view, either explicit or implicit, of many of the witnesses which appeared before your subcommittee. This was the explicit view of the Treasury Department and the view of those among the insurance company representatives who favored some variant of the so-called total income approach for the taxation of life insurance companies. Under this approach receipts from all sources, including receipts from premiums as well as investment income, are added together. Then deductions are allowed for amounts returned to policyholders and beneficiaries as payments of claims, and as policyholder dividends. In addition, deductions are allowed for increases in reserves set aside to meet future claims as well as deductions for the more usual business expenses.

Apart from those advocating some variant of the total income approach, other witnesses before your subcommittee believed underwriting income should be taxed in other ways. Certain of the witnesses suggested that underwriting income should be taxed to the extent that it is distributed to stockholders as dividends. Still others suggested that companies specializing in credit insurance, which tend to have large underwriting gains but small investment income should either be taxed more heavily than other companies or should not be taxed as life insurance companies. Implicitly this suggests that at least where underwriting income is large relative to the investment income it should be taxed in one manner or another.

Your subcommittee recognizes that if underwriting income is made a significant factor in the tax base developed for life insurance companies, a serious competitive problem might arise between stock and mutual life insurance companies. Under the total income approach, all amounts returned to policyholders as dividends are deductible in computing the taxable income of the company. While in the case of so-called underwriting income this can be viewed as merely the return to the policyholders of excessive premium charges, it is argued that this is not the case where investment income is returned to policyholders. The contention is made that investment is income generated at the level of the life insurance company from its investments, and that to the extent that this investment income is taxed to stock companies at the corporate level but not to mutual companies, there is discrimination against the former. Thus, it is argued that the competitive problem in the case of stock and mutual life insurance companies would require that both types of companies should be taxed upon their investment income not required for their reserves.

An additional problem presented under the total income approach arises from the nature of life insurance. It is stated that true income with respect to any given contract can be determined only over a very long period of time, namely, the life of the contract. Because of this, it has been suggested that if the total income approach is used, it is necessary to allow special deductions for additions to various reserves to cover contingencies which may arise with respect to a policy. For example, it has been suggested that special contingency reserves are required for contracts written on a nonparticipating basis, for extraordinary risk losses such as epidemics, or war disasters, for fluctuations in investment values, or the special hazards of disability and accident and health insurance, and for pension and profit-sharing

business (because of their tax-free status in the case of business handled through other than insurance companies).

The Treasury Department in its combination plan also makes allowance for this difficulty in determining what actual income is under the total income tax base by including in the tax base, in addition to free investment income, only half of any other income of a life insurance company. Others would approach this problem by not taxing the underwriting income at all until such time as it may be distributed to stockholders. In connection with this latter approach, however, it is pointed out that this permits the use of such funds in the operation of the company in the interval before distribution on a tax-free basis. Moreover, it presents a problem of determining when a penalty tax should be imposed for accumulations beyond the reasonable needs of the business.

III. SUBCOMMITTEE CONCLUSIONS

Your subcommittee spent 4 days in public hearings in November of 1958 on the problem of the proper tax treatment of life insurance companies. Following this, your subcommittee spent many hours in executive session discussing the various alternative proposals. In addition, it had the benefit of many days of public hearings held on this subject in prior years.

Despite its consideration of the subject, your subcommittee is not entirely satisfied with any of the suggestions which have been presented to it. As indicated in the foregoing report your subcommittee is aware of the fact that to omit from the tax base all underwriting income presents a serious problem of equity. At the same time, the so-called total income approach also appears to present serious problems, both in determining what the real income of a life insurance company is and also as to competitive problems which may be raised between stock and mutual companies.

The Treasury combination approach was designed to meet the various problems presented in your subcommittee's hearings. Although your subcommittee is concerned as to whether this approach also contains competitive problems, it appears to merit consideration by the full committee. Your subcommittee has, therefore, asked the Treasury Department, with the cooperation of the congressional staffs, to develop its proposal for consideration by the full committee. Your subcommittee has also asked the Treasury to be prepared, among other things, to indicate the effect of this plan on the competitive situation between stock and mutual companies as well as its effect on small life insurance companies.

Your subcommittee's report to this point has been expressed in terms of the basic or broad issues. It should nevertheless be understood that in addition to these broad issues there are many lesser, but nevertheless important, problems which must be dealt with in any bill taxing life insurance companies. Many of these issues were not yet fully developed at the time your subcommittee held its hearings in November of 1958. Your subcommittee believed that these problems could best be developed through the preparation of a bill by the Treasury Department in cooperation with the congressional staffs. The draft bill which resulted from this staff work is explained below. It has not been reviewed or approved by your subcommittee or any member thereof.

IV. EXPLANATION OF DRAFT BILL BASED ON TREASURY COMBINATION APPROACH

The bill accompanying this report is a substitute for all of the provisions of present law relating to the taxation of life insurance companies. Under the bill the code sections dealing with the taxation of life insurance companies are divided into four subparts. Subpart A defines a life insurance company and provides for the actual imposition of tax. The base on which this tax is imposed consists of two parts: (1) the investment income base, which is determined under subpart B of the draft, and (2) the gain or loss from operations, which is described in subpart C of the draft. Subpart D contains miscellaneous provisions necessary to the operation of the other subparts.

A. *Subpart A. Definition; tax imposed*

Subpart A consists of two sections: section 801, which defines a life insurance company, and section 802, which imposes the tax. With one minor exception, the definition of a life insurance company as it appears in the bill is substantially the same as under present law. The exception, which relates to the exclusion of deficiency reserves, is provided for in subsection (b)(4). This excludes such reserves for purposes of determining what are life insurance reserves, even though they are required by State law. Thus, such reserves will not be taken into account in determining whether life insurance reserves constitute more than 50 percent in a company's total reserves—a condition which must be met if a company is to be classified for tax purposes as a life insurance company. They will also not be taken into account in determining taxable income.

Section 802(a)(1) provides for the imposition of the regular corporate income tax (including the $25,000 surtax exemption) based upon "life insurance company taxable income." Paragraph (2) of section 802(a) provides an alternative maximum tax of 25 percent for capital gains, and also provides that in the computation of the so-called partial tax on life insurance company taxable income any amount included in the alternative tax base is to be excluded from the tax computation on life insurance company taxable income.

Subsection (b) of section 802 defines life insurance company taxable income. Paragraph (1) indicates that this in all cases includes "taxable investment income" as determined under subpart B. In addition, paragraph (2)(A) indicates that where the gain from operations, defined in subpart C, exceeds this taxable income, the tax base is increased by one-half of the amount by which the operating gains exceed the taxable investment income. This paragraph also provides that in the case of the so-called specialty companies the remaining half of any gains from operations, to the extent they exceed a floor, are to be included in the tax base. This is accomplished by providing that where the gains from operations amount to more than twice the investment yield then to the extent of this excess the 50 percent of gains from operations not already in the tax base is to be added. This investment yield is investment income (including tax-exempt interest, and the full dividends received) before the reserve deduction but after the deduction of investment expenses.

Subparagraphs (B) and (C) of paragraph (2) provide forc ases where the gain from operations is less than the taxable investment income, or where there is an actual loss from operations. Both where the gain from operations is less than the taxable investment income

(this in effect is an underwriting loss) and where there is no such gain, the draft provides for an offset against the taxable investment income which would otherwise be subject to tax. The effect of subparagraph (B) is to permit any excess of taxable investment income over gains from operations to be deducted from taxable investment income otherwise subject to tax in full in the case of the first $25,000 of such excess and to the extent of 50 percent in the case of any remaining excess. The same effect is achieved in subparagraph (C) where there is a loss from operations, by adding the taxable investment income to the loss from operations and allowing this amount as a deduction from taxable investment income, again in full in the case of the first $25,000 and to the extent of 50 percent with respect to any remaining amount.

B. Subpart B. Investment income

As implied by the name of the subpart, it deals with the portion of the tax base represented by taxable investment income, or by the part of the tax base which has sometimes been referred to as "phase one" of the life insurance company tax base.

Section 806(a) defines taxable investment income as net investment income less the policy and other contract liability deduction. Subsection (b) of this section defines gross investment income, or indicates the receipt items included, while subsection (c) defines net investment income, or indicates the deductions allowed in deriving net investment income from gross investment income.

Gross investment income is defined in section 806(b) as including interest, dividends, rents, and royalties, including amounts received in connection with leases and other agreements from which such income is derived. Paragraph (2) provides that gross income is to include gains from the sale or disposition of property but, since this is an investment income base only, it does not include gains attributable to sales of property used in carrying on the insurance business (such as the sale of the home office). Paragraph (3) indicates that gross income also includes income from any trade or business, apart from the insurance business. This would include, for example, income from the operation of a farm which an insurance company might have taken over as the result of the foreclosure of a mortgage.

Section 806(c) indicates the deductions available in going from gross investment income to net investment income. In general terms, these include any expenses incurred by the insurance company properly allocable to the investment income. Thus, investment expenses generally are deductible except that, as under present law, where general expenses of the insurance company are allocated to investment income, the total deduction for investment expenses is limited. In such cases the expenses are limited to an amount determined by taking into account the size of the investment assets held by the company and the size of the net investment income computed without this deduction. Other deductions allowed are real estate expenses (including taxes, but not including capital improvements), depletion, capital losses and other losses generally allowed under the Internal Revenue Code, and trade or business deductions generally. The trade or business deductions, however, are limited so as to exclude deductions attributable to carrying on the insurance business and also to deny any net operating loss carryover.

In addition to the customary deductions referred to above, in arriving at net investment income, deductions are allowed for tax-exempt

interest, a portion of partially tax-exempt interest (equivalent to the ratio of the normal tax rate to the total tax rate), and 85 percent of the dividend income received. These items are deductible (to the extent indicated) in arriving at net investment income since they were included in full in gross income.

A deduction also is allowed in arriving at net investment income as a small business relief measure. Thus, a deduction may be taken for 5 percent of the net investment income (computed without regard to this deduction) up to a maximum of $25,000. The maximum benefit of this deduction will thus be obtained with a company with a net investment income (without regard to this deduction) of $500,000.

As indicated previously, taxable investment income is net investment income less the policy and other contract liability deduction. Section 807 defines the policy and other contract liability deduction. Subsection (a) of this section indicates that this deduction consists of two parts: (1) a deduction of a proportion of investment income related to additions to life insurance reserves and (2) a deduction for interest paid. The deduction with respect to life insurance reserves is described in subsection (b) and the deduction for interest paid in subsection (c). However, these deductions with respect to life insurance reserves and interest paid are reduced, in the manner provided in subsection (d), so as not to provide a second allowance for tax-exempt income, partially tax-exempt interest and the 85-percent-dividends-received deduction, to the extent that such amounts have already been deducted in arriving at net investment income.

The deduction provided in section 807(b) with respect to life insurance reserves is referred to as the "deduction for investment yield on adjusted life insurance reserves." In arriving at the deduction with respect to life insurance reserves both the rate of interest assumed by the company in setting up these reserves and the reserves themselves are adjusted. The reserves as adjusted are multiplied by an especially computed interest rate, referred to as the "deduction rate."

The deduction rate is determined under paragraph (4) of section 807(b). This paragraph provides that the deduction rate is to be half-way between the actual rate of earnings of the insurance company in question on its investments, and an assumed interest rate. This assumed interest rate may be either the rate the individual insurance company used in calculating its own life insurance reserves or the average rate assumed by the industry for the prior year as determined by the Secretary or his delegate, whichever is the higher.

Paragraph (2) of section 807(b) indicates the adjustment to be made to the life insurance reserves of each company before the reserves are multiplied by the deduction rate. This paragraph indicates that for each percentage point which the deduction rate is above a company's own assumed interest rate, a reduction of 10 percent is to be made in its life insurance reserves. This adjustment is made only for tax purposes for the year in question. This adjustment is the same type of adjustment as that made under the so-called Menge formula, although the "deduction rate" used in this case only partially reflects the actual rate of earnings which would be used under the Menge suggestion. Paragraph (3) indicates how the average assumed interest rate for a company is to be determined.

As indicated previously, the deduction rate for an insurance company is determined in part by taking into account the taxpayer's actual rate of earnings during the year. This actual rate is obtained by dividing what is referred to as the taxpayer's "investment yield" by the taxpayer's average "assets" for the year. Paragraph (5) specifies for this purpose how investment yield is to be determined and paragraph (6) how assets are to be valued. Investment yield is the net investment income without the deductions for tax-exempt interest, partially tax-exempt interest, dividends received and small business. "Assets" in effect are defined as those held for investment purposes or for gain in a trade or business other than the insurance business. For this purpose real property and stock is valued at its current fair market value. Other assets are valued at their adjusted basis or the regular basis for tax purposes.

Subsection (c) of section 807 is concerned with the portion of the policy and other contract liability deduction which is for interest paid for contracts not involving life, accident, or health contingencies. This subsection indicates that a deduction for this purpose is allowed for interest on any indebtedness of the insurance company, interest paid on amounts left on deposit with an insurance company, including both those under supplementary contracts and policyholder dividends left on account with the company. In addition, a deduction is available for discounts allowed in the case of premiums paid in advance.

Subsection (d) of section 807 specifies the reduction to be made in the policy and other contract liability deduction for tax-exempt interest, partially tax-exempt interest and dividends received. As previously indicated, these amounts either in whole or in part have been deducted in arriving at net investment income. An adjustment in the policy and other contract liability deduction prevents a second allowance for these amounts. The reduction in this policy and other contract liability deduction are these otherwise deducted amounts multiplied by the ratio of the policy and other contract liability deduction (without this adjustment) plus the small business deduction to the investment yield.

Section 808 indicates the type of adjustments to be made for the taxable investment income base where a life insurance company either strengthens or weakens its life insurance reserves, that is, changes its reserves to conform to lower (or higher) interest additions to be made in the future, or changes the mortality assumptions on which the reserves are based. Where this reserve strengthening or weakening occurs, computations for the current taxable year or year of change are to be made on the old basis and for the following year are to be on the new basis.

C. Subpart C. Gain and loss from operations

This subpart deals with the portion of the tax base represented by gains (or losses) from operations, or by the part of the tax base which has sometimes been referred to as "phase two" of the life insurance company tax base. This is the portion of the tax base which under subpart A generally is reduced by 50 percent although as indicated in subpart A there are exceptions to this general rule applicable where

so-called specialty companies are involved and also where gains from operations are less than taxable investment income or where there is a loss from such operations.

Subpart C consists of four sections. Section 811 is the general operative provision defining gains and losses from operations; section 812 describes how increases or decreases in life insurance reserves, etc. are to be taken into account; section 813 defines dividends from policyholders, one of the major deductions permitted in determining gain or loss from operations; and section 812 describes the application of the operations loss carryover.

Section 811(a) and (b) define gain or loss from operations. "Gain from operations" is defined as the excess of certain gross receipts over certain deductions and the "loss from operations" is defined as the excess of the same deductions over the same gross receipts. Subsection (c) defines the gross receipts, or gross amount as it is referred to in the bill, and subsection (d) defines the deductions.

Section 811(c) provides that the gross amount is to include the following four categories of receipts:

(1) Net premiums, considerations and deposits received or accrued during the taxable year on insurance and annuity contracts;

(2) Decreases in life insurance reserves and unearned premiums and unpaid losses included in total reserves (further defined in sec. 812):

(3) Gains from the sale or other disposition of property; and

(4) All other amounts includible in gross income (including investment income).

Subsection (d) provides the following seven categories of deductions in computing gain or loss from operations:

(1) All claims, benefits, and losses during the year on insurance and annuity contracts (including supplementary contracts);

(2) Increases in life insurance reserves and unearned premiums and unpaid losses included in total reserves (further defined in sec. 812);

(3) Dividends to policy holders (further defined in sec. 813);

(4) The operations loss deduction (further defined in sec. 814);

(5) The same "small business" deduction which was allowed in computing the company's taxable investment income (5 percent of net investment income but not over $25,000);

(6) Amounts paid or incurred where another person assumes liabilities under insurance and annuity contracts (except reinsurance ceded); and

(7) Generally all other deductions generally allowable in computing taxable income wtih certain modifications (the modifications are described in subsec. (e) below).

The modifications provided in subsection (e) with respect to deductions otherwise generally allowable are as follows:

(1) No deduction is allowed for interest on the life insurance and other reserves described in section 812 since additions to such reserves already are allowed under subsection (d)(2) described above;

(2) No deduction is allowed for reserves for bad debts, although the deduction of actual bad debts is allowed;

(3) The charitable contribution deduction limitation of 5 percent is modified slightly to minimize complexity in the operation of this limitation;

(4) No deductions for amortization of bond premiums is allowed here (but is subsequently under sec. 817);

(5) The net operating loss deduction is not allowed since a new "operations loss deduction" (described in sec. 814) is allowed as a substitute;

(6) The deduction for partially tax-exempt interest is allowed only in the ratio of the normal tax rate (presently 30 percent) to the total tax rate (presently 52 percent); and

(7) In computing the deduction for dividends received, instead of limiting this deduction to 85 percent of taxable income it is limited to 85 percent of gains from operations computed without certain specified deductions.

Section 811(f) reduces the deductions otherwise allowed under this section in order to prevent a double allowance in the case of tax-exempt interest, partially tax-exempt interest, and the 85 percent of dividends excluded from income. Such amounts already have been accounted for since tax-exempt income is not includible in gross income and in the other two cases specific deductions are allowed under section 811(d). To allow other deductions, attributable to this income, also to be deducted under section 811(d) would result in a double allowance with respect to this income. To prevent this the regular deductions under this section are reduced by a ratio of the tax-exempt income, partially tax-exempt income, and the 85 percent of the dividends already deducted. This ratio is that fraction of the total net investment income (without the deductions for tax-exempt interest, dividends received, and small business) which is required to be added to the company's life insurance reserves under its reserve assumptions or required for interest on supplementary contracts, etc.

As indicated previously, section 812 specifies the effect that increases or decreases in life insurance and certain other reserves are to have in computing gain or loss from operations. As indicated above, decreases in these reserves increase the gain from operations and increases in these reserves result in deductions in computing gain or loss from operations. This is indicated in subsections (a) and (b) of section 812.

Subsection (c) of section 812 defines what constitutes a reserve for purposes of this computation. In addition to the regular life insurance reserves required by law (but not including deficiency reserves) reserves for this purpose include unearned premiums and unpaid losses not included in life insurance reserves, amounts to satisfy obligations under insurance or annuity contracts (including supplementary contracts) where these obligations are not provided for under life insurance reserves, dividend accumulations and other amounts held at interest, and premiums received in advance, etc.

Section 812 (d) deals with effects on deductions (or amounts included in income) where there had been changes made in the method of computing the reserves. Paragraph (1) refers to what is generally described as reserve strengthening or weakening. This paragraph provides in the case of reserve strengthening that the additional deduction which would otherwise be allowable because of an addition

to the reserve occurring in this strengthening process is to be taken into account ratably over a 10-year period rather than in a single year. The paragraph also provides the reverse treatment in the case of reserve weakening.

Paragraph (2) of section 812(d) provides that except where under subchapter C, dealing with corporate reorganizations, certain carry-overs of items are provided for, if in any year a company which previously was a life insurance company no longer qualifies, any adjustments remaining to be made will be taken into account in the prior taxable year.

Paragraph (3) of section 812(d) provides that an election to increase reserves for tax purposes, because computations are made on a preliminary term rather than a net level premiums basis, is not to be treated as a change in method of computing reserves and therefore that the deduction to be spread over the 10-year period where reserve strengthening or weakening occurs is not to include any amount attributable to this preliminary term election.

Section 813 deals with dividends to policyholders, which as indicated in section 811 are deductible in determining gain or loss from operations. Subsection (a) of section 813 defines dividends to policyholders as dividends and similar distributions to policyholders in their capacity as such but excluding interest.

Section 813(b) takes account of the fact that policyholder dividends usually are initially set up on a reserve basis. This subsection also makes it clear that policyholder dividends to be deductible must be payable either during the taxable year with respect to which declared or during the following taxable year.

Paragraph (2) of subsection (b) provides that the deduction for policyholder dividends shall not be an amount greater than that which would make the gain from operations equal to the taxable investment income.

Section 814 deals with the "operations loss deduction" which is similar to the net operating loss deduction available to ordinary corporations. Section 814(a) provides that the operations loss deduction for a year consists of carryovers of operations losses from prior years and carrybacks of operations losses from subsequent years. Subsection (b) provides that an operations loss, like the net operating loss of an ordinary corporation, can be carried back 3 years (but not to a year before 1958) and then forward for 5 subsequent years.

Subsection (c) provides that the loss to be carried back or forward is to be the "adjusted loss" for any taxable year. This is the loss from operations as otherwise computed if the taxable investment income does not exceed $25,000. Where the taxable investment income exceeds $25,000 the adjusted loss from operations is the excess of the regular loss from operations over the taxable investment income reduced by $25,000. Generally, limiting the adjusted loss to the excess of the regular loss from operations over a taxable investment income is necessary to reflect the fact that the loss from operations is first applied in reduction of taxable investment income and, therefore, to that extent is not available as a carryback or forward to another year. The allowance of the loss with respect to the first $25,000 of taxable income, however, is necessary to reflect the fact that under section 802 losses from operations may be offset in full (instead of to

the extent of 50 percent) against $25,000 of taxable investment income. The method of computing the operations loss deduction described in paragraph (2) of subsection (c) is similar to the method provided in the case of the ordinary net operating loss deduction.

D. Subpart D. Miscellaneous provisions

Subpart D contains certain miscellaneous provisions. There are three sections in this subpart; section 816, which is concerned with rules to be applied in determining gain or loss on the disposition of property; section 817, which is concerned with accounting provisions; and section 818, which is concerned with the tax treatment of foreign life insurance companies.

Section 816 provides, in effect, that the basis for determining gain on a sale or other disposition of property held before January 1, 1958, is to be the fair market value of the property on that date if that is higher than the cost or other basis of the property. This rule applies only when the company in question has been a life insurance company at all times after January 1, 1958. "Property" for this purpose does not include insurance and annuity contracts or inventory-type property. This new fair market value basis as of January 1, 1958, is provided because gains from the sale or exchange of capital assets previously have not been taxable to life insurance companies. This rule gives comparable treatment, therefore, to the rule provided in 1913 when other types of property were initially subject to the income tax.

Subsection (b) is concerned with capital loss carryovers. This subsection provides that capital losses arising before 1955 are not to be treated as carryovers to 1958 or subsequent years. Losses arising in the period 1955 to 1957, inclusive, are to be available for carryovers to 1958 and subsequent years, only if the company carried on an accident and health, or other nonlife insurance business during that prior period, and then only in the ratio of the 1957 nonlife reserves to total reserves. These rules are provided because no capital gains or losses were recognized for life insurance companies before 1955, and in the period from 1955 to 1957, inclusive, they were recognized only to the extent attributed to accident and health or other nonlife insurance business.

Section 817 is concerned with accounting provisions. Subsection (a) provides that, generally, computations in determining life insurance company taxable income are to be made on an accrual basis and to the extent not inconsistent with other income tax provisions in the manner required in making the annual statement to the insurance commissioners.

Section 817(b) provides that premiums on bonds generally are to be amortized and discounts on bonds are to be accrued, in accordance with the methods regularly used by the company, if its methods are reasonable. The amortization of premiums results in deductions and the accrual of discounts results in income.

Section 817(c) provides for certain adjustments which may be made for tax purposes in the computation of life insurance reserves where a company computes its reserves on a preliminary term basis. This subsection provides that an insurance company with reserves on this basis may elect to convert them to a net level basis for tax pur-

poses, but if it does so all preliminary term reserves must be so treated and that treatment must be adhered to for subsequent years unless the Secretary or his delegate approves a change. The reserves may be converted to a net level premium basis under any method approved by the Secretary or his delegate as reasonably approximating the result which would be obtained if an exact method were used.

Section 817(d) provides that no item may be deducted more than once in computing taxable investment income and once in computing gain or loss from operations.

Section 818 deals with the tax treatment of foreign life insurance companies. Subsection (a) provides that a foreign life insurance company carrying on a life insurance business within the United States is to be taxable in the same manner as a domestic life insurance company (if it would qualify under the definition of a life insurance company). Subsection (b) provides a special rule where the surplus of a foreign life insurance company which is held in the United States is less than a pro rata portion of its total surplus allocable to its United States business. In such a case the subsection provides that the policy and other contract liability deduction, for purposes of computing taxable investment income, is to be reduced by the portion of the surplus not held in the United States which is allocable to United States business, multiplied by the company's "deduction rate." Thus, such a company will not receive the policy and other contract liability deduction with respect to the portions of its surplus allocable to United States business which is held outside of the United States since the assets represented by this surplus are not included in the net investment income on which United States tax is computed.

E. Technical amendments and effective date

Section 3 of the bill contains certain technical amendments required outside of part I of subchapter L, which relates to life insurance companies. Technical amendments are required in the case of section 841, dealing with credits for foreign taxes; section 381, dealing with carryovers and certain corporate reorganizations; section 1016(a), relating to rules in adjusting the basis of property; section 1232(a)(2)(C), relating to bonds and other evidences of indebtedness, and other conforming changes required in cross-references.

Section 4 of the bill provides that this bill is to apply to taxable years beginning after December 31, 1957.

×

COMMITTEE ON WAYS AND MEANS

WILBUR D. MILLS, Arkansas, *Chairman*

NOBLE J. GREGORY, Kentucky
AIME J. FORAND, Rhode Island
HERMAN P. EBERHARTER, Pennsylvania [1]
CECIL R. KING, California
THOMAS J. O'BRIEN, Illinois
HALE BOGGS, Louisiana
EUGENE J. KEOGH, New York
BURR P. HARRISON, Virginia
FRANK M. KARSTEN, Missouri
A. S. HERLONG, Jr., Florida
EUGENE J. McCARTHY, Minnesota
FRANK IKARD, Texas
THADDEUS M. MACHROWICZ, Michigan
JAMES B. FRAZIER, Jr., Tennessee

DANIEL A. REED, New York
THOMAS A. JENKINS, Ohio
RICHARD M. SIMPSON, Pennsylvania
ROBERT W. KEAN, New Jersey
NOAH M. MASON, Illinois
HAL HOLMES, Washington
JOHN W. BYRNES, Wisconsin
ANTONI N. SADLAK, Connecticut
HOWARD H. BAKER, Tennessee
THOMAS B. CURTIS, Missouri

LEO H. IRWIN, *Clerk*
JOHN M. MARTIN, Jr., *Assistant Clerk*
THOMAS A. MARTIN, *Minority Adviser*
GERARD M. BRANNON, *Professional Staff*

SUBCOMMITTEE ON INTERNAL REVENUE TAXATION

WILBUR D. MILLS, Arkansas, *Chairman*

NOBLE J. GREGORY, Kentucky
THOMAS J. O'BRIEN, Illinois
FRANK IKARD, Texas

RICHARD M. SIMPSON, Pennsylvania
ROBERT W. KEAN, New Jersey
HOWARD H. BAKER, Tennessee

[1] Died September 9, 1958.

REPORT ON THE TAXATION OF LIFE INSURANCE COMPANIES

I. METHODS OF TAXING LIFE INSURANCE COMPANIES EMPLOYED IN THE PAST

The taxation of life insurance companies almost from the initiation of the income tax has presented difficult problems in determining an equitable tax base. The methods of taxing life insurance companies in fact has changed with considerable frequency since the adoption of the income tax in 1913.

Before 1921, life insurance companies in general were taxed under the regular provisions of the income tax laws applicable to ordinary corporations. This was quite similar to what now is referred to as the "total income" approach. From 1921 through 1957, life insurance companies have been taxed only with respect to investment income (generally rents, dividends, and interest). Within this broad category, however, quite different methods have been employed since 1921. From 1921 to 1941 an individual company-by-company approach was followed. Each company was taxed on its net investment income minus a specified percentage of its own required insurance reserves for policyholders. This has been referred to as taxing a company on its free investment income. From 1921 to 1931 companies were allowed a deduction equal to 4 percent of their own reserves and from 1932 to 1941 a deduction equal to 3¾ percent of these reserves.

In 1942 this company-by-company method of determining the portion of a company's free investment income was dropped and an overall, or industrywide, method of determining free investment income was substituted. From 1942 to 1948 the portion of net investment income allowed as a deduction was computed by the Secretary of the Treasury for the entire industry, based in part (65 percent) on the prior years' average reserve requirements and in part (35 percent) on the assumption that an investment income rate of return equal to 3¼ percent was required on total industry reserves. Once the Secretary computed such a reserve deduction for the entire industry, he expressed this deduction as a percentage of the investment income of the entire industry for the prior year, and each company then applied this percentage to its own net investment income for the current year. For 1949 and 1950 one modification was made in this method of taxing life insurance companies: the deduction computed by the Secretary was based entirely (instead of only to the extent of 65 percent) on the prior year's average reserve requirements of the industry.[1]

[1] In addition, under the 1950 formula companies having smaller net investment incomes than their reserve requirements were eliminated from the group from which the Secretary determined the ratio.

For the years 1951 through 1957 Congress in effect continued to tax the life insurance industry on a uniform percentage of net investment income, but no longer based this upon a determination by the Secretary of the Treasury as to industrywide reserve requirements. Instead, from 1951 through 1954 life insurance companies were in effect permitted to deduct 87½ percent of their investment income and required to pay tax at the regular corporate rate on the remaining 12½ percent.[2] For the years 1955 through 1957 also, life insurance companies were allowed to deduct a specified percentage of their net investment income. For this period the deduction was 87½ percent of the first $1 million of net investment income and 85 percent of any remaining income. However, the 1955–57 law also made several changes in the base on which the life insurance companies are taxed, including broadening the definition of net investment income, taxing the income of life insurance companies from accident and health and other nonlife operations in substantially the same manner as income of a mutual casualty insurance company, and providing a maximum tax for small new companies based upon the overall income as reported to State insurance commissioners.

The laws enacted since 1949, however, have been of a temporary or stopgap nature, with the result that, in the absence of any legislation to the contrary, the 1942 formula (but with modifications in the manner of computing investment income, etc., provided in the 1955 law) is applicable for 1958 and subsequent years.

Table 1 shows the percentages of net investment income deductible in computing taxable income under the various laws applicable to the years from 1942 through 1957. Of the four formulas used in this period, two, the 1942 formula and the 1950 formula, result in varying percentage deductions for different years. Table 2 shows the percentages which would have been applicable under these two formulas had they been applicable throughout the period 1942–57.

TABLE 1.—*Percentages of net investment income of life insurance companies deductible in computing taxable income, 1942–57*

Calendar year	Formula applicable	Percent of net investment income deductible	Calendar year	Formula applicable	Percent of net investment income deductible
1942	1942	93.00	1950	1950 stopgap	90.63
1943	1942	91.98	1951	1951 stopgap	87.50
1944	1942	92.61	1952	do	87.50
1945	1942	95.39	1953	do	87.50
1946	1942	95.95	1954	do	87.50
1947	1942	[1] 100.66	1955	1955 stopgap	[2] 87.5–85
1948	1942	[1] 102.43	1956	do	[2] 87.5–85
1949	1950 stopgap	93.55	1957	do	[2] 87.5–85

[1] No tax was paid in these years.
[2] 87.5 percent is deductible on the first $1,000,000 of net investment income and 85 percent on any remaining investment income.

[2] Actually, the tax for the years 1951 through 1954 was stated as 6½ percent of each company's net investment income (3¾ percent of the first $200,000). However, this is mathematically the same as a tax at the rate of 52 percent (30 percent on the first $25,000) on net investment income after deducting 87½ percent of this income.

TABLE 2.—*Percentages of net investment income of life insurance companies which would have been deductible under the "1942 formula" and "1950 formula," 1942–57*

Calendar year	1942 formula	1950 formula	Calendar year	1942 formula	1950 formula
	Percent	*Percent*		*Percent*	*Percent*
1942	93.00	(1)	1951	93.89	87.76
1943	91.98	2 91.12	1952	91.81	85.43
1944	92.61	2 91.13	1953	87.98	81.67
1945	95.39	2 93.22	1954	85.00	78.58
1946	95.95	2 93.15	1955	82.38	76.00
1947	100.66	2 96.52	1956	80.28	73.84
1948	102.43	2 97.55	1957	77.66	70.69
1949	100.83	2 93.55	1958	75.53	68.54
1950	96.72	90.63			

1 Not available.
2 These figures are approximations only.

II. PROBLEMS ARISING IN CONNECTION WITH THE TAXATION OF LIFE INSURANCE COMPANIES

In part problems have arisen in the taxation of life insurance companies from disagreement as to what constituted a proper investment income-tax base. This in fact was the consideration which has caused the shift in the methods of calculating free investment income under the various formulas which have been employed since 1942. Moreover, a dissatisfaction with the free investment income base reached under the 1955 stopgap formula is an important factor in accounting for the subcommittee's current consideration of the tax treatment of life insurance companies. However, this is not the only concern at this time. The point was made during the course of the subcommittee hearings in November 1958 that imposing a tax only on free net investment income misses entirely an important segment of the profits of many life insurance companies, or at least omits funds which companies treat like profits, since they retain them in surplus and subsequently, in some cases, pay them out as dividends to stockholders. The profits or funds referred to are gains from mortality savings and gains from overcharges in connection with the costs of selling and servicing policies. However, the point was also made during the hearings that any attempt to tax all of these gains on an annual basis without adjustment would raise serious competitive problems between mutual and stock life insurance companies, because of the way in which funds are returned to policyholders in the case of participating policies. The problems of taxing life insurance companies are discussed below under two headings: "Problems In Developing An Investment Income Tax Base" and "Problems In Developing a Total Income Base."

A. Problems in developing an investment income base

The free investment income approach in general holds that a life insurance company has income which is properly subject to tax at the company level only to the extent that investment income (after payment of investment expenses) is not needed in a reserve to pay future claims of policyholders and beneficiaries. Thus the problems in developing a free investment income base are primarily concerned with the determination of the policy and other contract liability deduction, or in general terms the deduction allowed for additions of interest to the reserves.

Various methods have been used, or suggested, as devices for measuring the appropriate size of the reserve deduction. Probably the most obvious would be to permit each company to deduct its own additions to reserves. This has not been used in any of the formulas which have been applicable in the past presumably because the proportion of the reserves which are built up through the use of investment income (as distinct from the proportion built up through premiums) is, in part at least, a matter within the control of the individual insurance company. Thus, it is stated that to permit an insurance company to deduct its own additions to reserves based upon its own assumed interest rate would in effect let such a company to a large extent determine its own tax liability. Moreover, it has been suggested that this would encourage companies to follow the policy of allocating a large proportion of their investment income to these reserves, with the result that they might be charging less than a safe margin of premiums.

The closest Congress has come to taxing insurance companies on the basis of each company's own addition to reserves was in the period from 1921 to 1942 when the companies were allowed a deduction equal to a specific percentage of their own reserves (4 percent from 1921 to 1931 and 3¾ percent from 1932 to 1941). While the use of a specified percentage applied to a company's own reserves in determining the policy and other contract liability deduction reduced somewhat the extent to which companies could determine their own tax, this element was still present since the specified percentage was applied individually to each company's reserves. Thus, the deduction varied from company to company, depending on the size of the reserve to which the percentage was applied.

It apparently was to avoid this differentiation among companies on the basis of whether they followed liberal or conservative methods in establishing their reserves that Congress in 1942 shifted over to an industrywide basis for determining the appropriate reserve and other contract liability deduction.

For the period 1942 through 1948 what in effect were two different methods of determining the appropriate size of the reserve deduction for the entire industry were used and then combined into a single industrywide ratio. One method of computing the industrywide reserve deduction was to determine the average deduction for the entire industry in each prior year. For the 2 years 1949 and 1950, with certain minor adjustments, this was in fact the only method used in computing the ratio. The second element in the 1942 formula applied to total industry reserves of the prior year an assumed interest rate of 3¼ percent. This deduction, weighted 35 percent, together with the industrywide prior year's experience deduction weighted 65 percent, then was expressed as a percentage of industrywide investment income for the prior year. The percentage so derived was then applied to the individual investment income of each company to determine its individual reserve deduction.

Both the combination formula used from 1942 to 1948, inclusive, and the formula used in 1949 and 1950 which depended solely on prior year's experience, were industrywide formulas. Thus, both avoided the difficulty of treating companies with conservatively financed reserves more harshly than companies with more liberally financed reserves, the problem implicit in any attempt to allow individual

companies to use their own additions to reserves. However, it has been suggested to your subcommittee that both of these industry-wide formulas present problems in that the policy reserve deduction obtained under them does not vary with the individual needs of the company, but only as their investment income increases or decreases. Thus, under both of these formulas it is argued that the policy reserve deductions, expressed on an industrywide basis, bear no relationship to the real reserve requirements of individual companies.

The 35 percent portion of the 1942 formula which was based upon an assumed investment rate of return of 3¼ percent presented another problem. Since industrywide reserve requirements actually were based upon a rate of return below this, as actual rates of return shrunk this, taken in combination with the prior year's earning experience, resulted in a ratio for 1947, 1948, and 1949 (although the latter was not applied) in excess of 100 percent of net investment income received. Thus, under the 1942 formula no part of a life insurance company's investment income was, or would have been, subject to tax during these years. This absence of any tax with respect to life insurance companies in these years highlighted the difficulties with the 1942 formula. However, as already indicated, even apart from this aspect of that formula it could be considered inadequate in that it did not recognize varying needs of individual companies.

As a result of further study of the tax treatment of life insurance companies, in 1951 still another technique of computing the reserve deduction was adopted. In effect, this same method, although with varying percentages, was followed from the year 1951 through the year 1957. Under this formula all life insurance companies were assumed to need a specified percentage of their net investment income to meet policyholder reserve requirements. From 1951 through 1954 this was assumed to be a flat 87½ percent. For 1955 through 1957 the percentage applied varied with the amount of net investment income, being 87½ percent on the first million dollars of such income and 85 percent on the balance. It has been indicated that such formulas continued the basic problem of the 1942 and 1950 formulas since they also were on an industrywide basis, and thus ignored the needs of individual companies. In addition, it has been pointed out that such formulas ignored the fact that from year to year actual earnings varied from the assumed rate on which the reserves were established and, therefore, that from year to year varying percentages of net investment income were needed by life insurance companies, even on an industry-wide basis, to meet reserve requirements.

The experience with varying formulas for determining reserve requirements has suggested to many that an individual company basis for determining needs is desirable, but only if some method is determined which for tax purposes does not vary additions to reserves, depending upon whether a company has established its reserves on a liberal or conservative basis. One formula suggested during the hearings—which has been referred to as the "Menge" formula—was designed to attain this result. This formula would base the reserve deduction on an individual company basis, but instead of using each company's assumed rate of earnings applied to its reserves, would use the company's actual rate of earnings applied to the reserves which a company would have established (usually smaller than its actual

reserves) had its reserves been built on the basis of the current actual earnings rate.

Such a formula, it is argued, avoids the problem of varying assumed earnings rates which may be employed by different companies. Since it is a company-by-company approach it also is stated to avoid the problems raised with respect to an industrywide formula which neglects individual company variations in need. One difficulty suggested with such a formula, however, is that, to some degree at least, it permits a company's reserve deduction to vary depending upon whether or not the company is able to obtain a high rate of return on investments. Thus, it is pointed out that under this formula those which are able to obtain a high rate of earnings on their assets would receive more generous deductions than others whose earnings rate is less. Because of this problem it is argued that some combination of assumed rates on reserves and actual earnings rates would be more appropriate. The Treasury suggestion, which is incorporated in a draft print described subsequently in this report, provides a deduction rate half way between the actual earnings rate of the individual company and an assumed rate of interest on the reserve. The assumed rate in this case is either the average for the industry in the prior year or the rate assumed by the individual company in establishing its own reserves, whichever is higher. It has been suggested that using the industry average in this case where the assumed rate of an individual company is relatively low avoids penalizing those who finance their reserves on a conservative basis.

B. Problems in developing a total income base

During the subcommittee hearings it was suggested that any method of taxing life insurance companies which depended solely upon taxing a portion of investment income would miss a significant segment of income realized by many life insurance companies. The income referred to is underwriting income. It is derived from premium charges which are in excess of the charges required to meet the claims of policyholders and their beneficiaries. Larger premiums than required for this purpose may be charged because of several factors. First, larger premiums than are necessary to meet claims may be charged because the insured persons live longer than assumed under the mortality tables used in estimating the necessary premiums. Secondly, premiums may be larger than necessary to meet claims because the so-called loading charges, or expenses of "putting the policy on the books" and servicing the policies once they are written, are smaller than anticipated. In addition, premiums may also include amounts over and above that calculated as necessary to pay claims.

These premium charges in excess of amounts ultimately required to meet claims, or underwriting income, can be held in surplus, paid out to stockholders, or paid out to policyholders. While in the latter case this can be viewed as merely a return of overcharges to the policyholder, it has been suggested this is not the case where the underwriting income is held in surplus, or where it is paid out to stockholders as dividends. It is contended that where such amounts are paid out to stockholders, there has been a payment made by the policyholder from which the stockholder derived a benefit and which therefore is properly classified as income. During the period the underwriting income is held in surplus, it is claimed that this income is substantially equivalent in effect to surplus derived through retained earnings.

In view of the considerations expressed above, many believe that in any satisfactory tax base for life insurance companies allowance must be made for underwriting profits. This was the view, either explicit or implicit, of many of the witnesses which appeared before your subcommittee. This was the explicit view of the Treasury Department and the view of those among the insurance company representatives who favored some variant of the so-called total income approach for the taxation of life insurance companies. Under this approach receipts from all sources, including receipts from premiums as well as investment income, are added together. Then deductions are allowed for amounts returned to policyholders and beneficiaries as payments of claims, and as policyholder dividends. In addition, deductions are allowed for increases in reserves set aside to meet future claims as well as deductions for the more usual business expenses.

Apart from those advocating some variant of the total income approach, other witnesses before your subcommittee believed underwriting income should be taxed in other ways. Certain of the witnesses suggested that underwriting income should be taxed to the extent that it is distributed to stockholders as dividends. Still others suggested that companies specializing in credit insurance, which tend to have large underwriting gains but small investment income should either be taxed more heavily than other companies or should not be taxed as life insurance companies. Implicitly this suggests that at least where underwriting income is large relative to the investment income it should be taxed in one manner or another.

Your subcommittee recognizes that if underwriting income is made a significant factor in the tax base developed for life insurance companies, a serious competitive problem might arise between stock and mutual life insurance companies. Under the total income approach, all amounts returned to policyholders as dividends are deductible in computing the taxable income of the company. While in the case of so-called underwriting income this can be viewed as merely the return to the policyholders of excessive premium charges, it is argued that this is not the case where investment income is returned to policyholders. The contention is made that investment is income generated at the level of the life insurance company from its investments, and that to the extent that this investment income is taxed to stock companies at the corporate level but not to mutual companies, there is discrimination against the former. Thus, it is argued that the competitive problem in the case of stock and mutual life insurance companies would require that both types of companies should be taxed upon their investment income not required for their reserves.

An additional problem presented under the total income approach arises from the nature of life insurance. It is stated that true income with respect to any given contract can be determined only over a very long period of time, namely, the life of the contract. Because of this, it has been suggested that if the total income approach is used, it is necessary to allow special deductions for additions to various reserves to cover contingencies which may arise with respect to a policy. For example, it has been suggested that special contingency reserves are required for contracts written on a nonparticipating basis, for extraordinary risk losses such as epidemics, or war disasters, for fluctuations in investment values, or the special hazards of disability and accident and health insurance, and for pension and profit-sharing

business (because of their tax-free status in the case of business handled through other than insurance companies).

The Treasury Department in its combination plan also makes allowance for this difficulty in determining what actual income is under the total income tax base by including in the tax base, in addition to free investment income, only half of any other income of a life insurance company. Others would approach this problem by not taxing the underwriting income at all until such time as it may be distributed to stockholders. In connection with this latter approach, however, it is pointed out that this permits the use of such funds in the operation of the company in the interval before distribution on a tax-free basis. Moreover, it presents a problem of determining when a penalty tax should be imposed for accumulations beyond the reasonable needs of the business.

III. SUBCOMMITTEE CONCLUSIONS

Your subcommittee spent 4 days in public hearings in November of 1958 on the problem of the proper tax treatment of life insurance companies. Following this, your subcommittee spent many hours in executive session discussing the various alternative proposals. In addition, it had the benefit of many days of public hearings held on this subject in prior years.

Despite its consideration of the subject, your subcommittee is not entirely satisfied with any of the suggestions which have been presented to it. As indicated in the foregoing report your subcommittee is aware of the fact that to omit from the tax base all underwriting income presents a serious problem of equity. At the same time, the so-called total income approach also appears to present serious problems, both in determining what the real income of a life insurance company is and also as to competitive problems which may be raised between stock and mutual companies.

The Treasury combination approach was designed to meet the various problems presented in your subcommittee's hearings. Although your subcommittee is concerned as to whether this approach also contains competitive problems, it appears to merit consideration by the full committee. Your subcommittee has, therefore, asked the Treasury Department, with the cooperation of the congressional staffs, to develop its proposal for consideration by the full committee. Your subcommittee has also asked the Treasury to be prepared, among other things, to indicate the effect of this plan on the competitive situation between stock and mutual companies as well as its effect on small life insurance companies.

Your subcommittee's report to this point has been expressed in terms of the basic or broad issues. It should nevertheless be understood that in addition to these broad issues there are many lesser, but nevertheless important, problems which must be dealt with in any bill taxing life insurance companies. Many of these issues were not yet fully developed at the time your subcommittee held its hearings in November of 1958. Your subcommittee believed that these problems could best be developed through the preparation of a bill by the Treasury Department in cooperation with the congressional staffs. The draft bill which resulted from this staff work is explained below. It has not been reviewed or approved by your subcommittee or any member thereof.

IV. EXPLANATION OF DRAFT BILL BASED ON TREASURY COMBINATION APPROACH

The bill accompanying this report is a redraft of all of the provisions relating to the taxation of life insurance companies. Under the bill the code sections dealing with the taxation of life insurance companies are divided into four subparts. Subpart A defines a life insurance company and provides for the actual imposition of tax. The base on which this tax is imposed consists of two parts: (1) the investment income base, which is determined under subpart B of the draft, and (2) the gain or loss from operations, which is described in subpart C of the draft. Subpart D contains miscellaneous provisions necessary to the operation of the other subparts.

A. *Subpart A. Definition; tax imposed*

Subpart A consists of two sections: section 801, which defines a life insurance company, and section 802, which imposes the tax. With one minor exception, the definition of a life insurance company as it appears in the bill is substantially the same as under present law. The exception which relates to the exclusion of deficiency reserves is provided for in subsection (b)(4). This excludes such reserves for purposes of determining what are life insurance reserves, even though they are required by State law. Thus, such reserves will not be taken into account in determining whether life insurance reserves constitute more than 50 percent in a company's total reserves—a condition which must be met if a company is to be classified for tax purposes as a life insurance company.

Section 802(a)(1) provides for the imposition of the regular corporate income tax (including the $25,000 surtax exemption) based upon "life insurance company taxable income." Paragraph (2) of section 802(a) provides an alternative maximum tax of 25 percent for capital gains, and also provides that in the computation of the so-called partial tax on life insurance company taxable income any amount included in the alternative tax base is to be excluded from the tax computation on life insurance company taxable income.

Subsection (b) of section 802 defines life insurance company taxable income. Paragraph (1) indicates that this in all cases includes "taxable investment income" as determined under subpart B. In addition, paragraph (2)(A) indicates that where the gain from operations, defined in subpart C, exceeds this taxable income, the tax base is increased by one-half of the amount by which the operating gains exceed the taxable investment income. This paragraph also provides that in the case of the so-called specialty companies the remaining half of any gains from operations, to the extent they exceed a floor, are to be included in the tax base. This is accomplished by providing that where the gains from operations amount to more than twice the investment yield then to the extent of this excess the 50 percent of gains from operations not already in the tax base is to be added. This investment yield is investment income (including tax-exempt interest, and the full dividends received) before the reserve deduction but after the deduction of investment expenses.

Subparagraphs (B) and (C) of paragraph (2) provide forc ases where the gain from operations is less than the taxable investment income, or actually results in a loss. Both where the gain from operations is less than the taxable investment income (this in effect is an

underwriting loss) and where there is no such gain, the draft provides for an offset against the taxable investment income which would otherwise be subject to tax. The effect of subparagraph (B) is to permit any excess of taxable investment income over gains from operations to be deducted in full from taxable investment income otherwise subject to tax, in the case of the first $25,000 of such excess and to the extent of 50 percent in the case of any remaining excess. The same effect is achieved in subparagraph (C) where there is a loss from operations, by adding the taxable investment income to the loss from operations and allowing this amount as a deduction from taxable investment income, again in full in the case of the first $25,000 and to the extent of 50 percent with respect to any remaining amount.

B. Subpart B. Investment income

As implied by the name of the subpart, it deals with the portion of the tax base represented by taxable investment income, or by the part of the tax base which has sometimes been referred to as "phase one" of the life insurance company tax base.

Section 806(a) defines taxable investment income as net investment income less the policy and other contract liability deduction. Subsection (b) of this section defines gross investment income, or indicates the receipt items included, while subsection (c) defines net investment income, or indicates the deductions allowed in deriving net investment income from gross investment income.

Gross investment income is defined in section 806(b) as including interest, dividends, rents, and royalties, including amounts received in connection with leases and other agreements from which such income is derived. Paragraph (2) provides that gross income is to include gains from the sale or disposition of property but, since this is an investment income base only, it does not include gains attributable to sales of property used in the insurance business (such as the sale of the home office). Paragraph (3) indicates that gross income also includes income from any trade or business, apart from the insurance business. This would include, for example, the operation of a farm which an insurance company might have taken over as the result of the foreclosure of a mortgage.

Section 806(c) indicates the deductions available in going from gross investment income to net investment income. In general terms, these include any expenses incurred by the insurance company properly allocable to the investment income. Thus, investment expenses generally are deductible except that, as under present law, where general expenses of the insurance company are allocated to investment income, the total deduction for investment expenses is limited. In such cases the expenses are limited to an amount determined by taking into account the size of the investment assets held by the company and the size of the net investment income computed without this deduction. Other deductions allowed are real estate expenses (including taxes, but not including capital improvements), depletion, capital losses and other losses generally allowed under the Internal Revenue Code, and trade or business deductions generally. The trade or business deductions, however, are limited so as to exclude deductions attributable to the insurance business and also to deny any net operating loss carryover.

In addition to the customary deductions referred to above, in arriving at net investment income, deductions are allowed for tax-exempt

interest, a portion of partially tax-exempt interest (equivalent to the ratio of the normal tax rate to the total tax rate), and 85 percent of the dividend income received. These items are deductible to the extent indicated in arriving at net investment income since they were included in full in gross income.

A deduction also is allowed in arriving at net investment income as a small business relief measure. Thus, a deduction may be taken for 5 percent of the net investment income (computed without regard to this deduction) up to a maximum of $25,000. The maximum benefit of this deduction will thus be obtained with a company with a net investment income (without regard to this deduction) of $500,000.

As indicated previously, taxable investment income is net investment income less the policy and other contract liability deduction. Section 807 defines the policy and other contract liability deduction. Subsection (a) of this section indicates that this deduction consists of two parts: (1) a deduction of a proportion of investment income related to additions to life insurance reserves and (2) a deduction for interest paid. The deduction with respect to life insurance reserves is described in subsection (b) and the deduction for interest paid in subsection (c). However, these deductions with respect to life insurance reserves and interest paid are reduced, in the manner provided in subsection (d), so as not to provide a second allowance for tax-exempt income, partially tax-exempt interest and the 85-percent-dividends-received deduction, since such amounts have already been deducted in arriving at net investment income.

The deduction provided in section 807(b) with respect to life insurance reserves is referred to as the "deduction for investment yield on adjusted life insurance reserves." This subsection in arriving at the deduction with respect to life insurance reserves adjusts both the rate of interest assumed by the company in setting up these reserves and the reserves themselves. In the bill the reserves as adjusted are multiplied by an especially computed interest rate, referred to as the "deduction rate."

The deduction rate is determined under paragraph (4) of section 807(b). This paragraph provides that the deduction rate is to be half-way between the actual rate of earnings of the insurance company in question on its investments, and an assumed interest rate. This assumed interest rate may be either the rate the individual insurance company used in calculating its own life insurance reserves or may be the average rate assumed by the industry for the prior year as determined by the Secretary or his delegate.

Paragraph (2) of section 807(b) indicates the adjustment to be made to the life insurance reserves of each company before the reserves are multiplied by the deduction rate. This paragraph indicates that for each percentage point which the deduction rate is above a company's own assumed interest rate, a reduction of 10 percent is to be made in its life insurance reserves. This adjustment is made only for tax purposes for the year in question. This adjustment is the same type of adjustment as that made under the so-called Menge formula, although the "deduction rate" used in this case only partially reflects the actual rate of earnings which would be used under the Menge suggestion. Paragraph (3) indicates how the average assumed interest rate for a company is to be determined.

As indicated previously, the deduction rate for an insurance company is determined in part by taking into account the taxpayer's actual rate of earnings during the year. This actual rate is obtained by dividing what is referred to as the taxpayer's "investment yield" by the taxpayer's average "assets" for the year. Paragraph (5) specifies for this purpose how investment yield is to be determined and paragraph (6) how assets are to be valued. Investment yield is the net investment income without the deductions for tax-exempt interest, partially tax-exempt interest, dividends received and small business. "Assets" in effect are defined as those held for investment purposes or for gain in a trade or business other than the insurance business. For this purpose real property and stock is valued at its current fair market value. Other assets are valued at their adjusted basis or the regular basis for tax purposes.

Subsection (c) of section 807 is concerned with the portion of the policy and other contract liability deduction which is for interest paid for contracts not involving life, accident, or health contingencies. This subsection indicates that a deduction for this purpose is allowed for interest on any indebtedness of the insurance company, interest paid on amounts left on deposit with an insurance company, including both supplementary contracts and also interest on policyholder dividends left on account with the company. In addition, a deduction is available for discounts allowed in the case of premiums paid in advance.

Subsection (d) of section 807 specifies the reduction to be made in the policy and other contract liability deduction for tax-exempt interest, partially tax-exempt interest and dividends received. As previously indicated, these amounts either in whole or in part have been deducted in arriving at net investment income. An adjustment in the policy and other contract liability deduction prevents a second allowance for these amounts. The reductions in this policy and other contract liability deduction are these otherwise deducted amounts multiplied by a ratio. This ratio is the proportion of the investment yield (net investment income with adjustments) represented by the policy and other contract liability deduction (without this adjustment) plus the small business deduction. This ratio is applied to the amount of tax-exempt income, partially tax-exempt income, and the 85 percent of the dividends received which are deducted in arriving at net investment income. The product obtained then reduces the policy and other contract liability deduction.

Section 808 indicates the type of adjustments to be made for the taxable investment income base where a life insurance company either strengthens or weakens its life insurance reserves, that is, changes its reserves on the assumption that it needs more premium income (because it will receive less investment income or because of changes in mortality experience) for such reserves or vice versa. Where this reserve strengthening or weakening occurs, computations for the current taxable year or year of change are to be made on the old basis and for the following year are to be on the new basis.

C. Subpart C. Gain and loss from operations

This subpart deals with the portion of the tax base represented by gains (or losses) from operations, or by the part of the tax base which has sometimes been referred to as "phase two" of the life insurance company tax base. This is the portion of the tax base which under

subpart A generally is reduced by 50 percent although as indicated in subpart A there are exceptions to this general rule applicable where so-called specialty companies are involved and also where gains from operations are less than taxable investment income or where there is a loss from such operations.

Subpart C consists of four sections. Section 811 is the general operative provision defining gains and losses from operations; section 812 describes how increases or decreases in life insurance reserves, etc. are to be taken into account; section 813 defines dividends from policyholders, one of the major deductions permitted in determining gain or loss from operations; and section 812 describes the application of the operations loss carryover.

Section 811(a) and (b) define gain or loss from operations. "Gain from operations" is defined as the excess of certain gross receipts over certain deductions and the "loss from operations" is defined as the excess of the same deductions over the same gross receipts. Subsection (c) defines the gross receipts, or gross amount as it is referred to in the bill, and subsection (d) defines the deductions.

Section 811(c) provides that the gross amount is to include the following four categories of receipts:

(1) Net premiums received or accrued during the taxable year on insurance and annuity contracts;

(2) Decreases in life insurance reserves and unearned premiums and unpaid losses included in total reserves (further defined in sec. 812):

(3) Gains from the sale or other disposition of property; and

(4) All other amounts includible in gross income (including investment income).

Subsection (d) provides the following seven categories of deductions in computing gain or loss from operations:

(1) All claims, benefits, and losses during the year on insurance and annuity contracts (including supplementary contracts);

(2) Increases in life insurance reserves and unearned premiums and unpaid losses included in total reserves (further defined in sec. 812);

(3) Dividends to policy holders (further defined in sec. 813);

(4) The operations loss deduction (further defined in sec. 814);

(5) The same "small business" deduction which was allowed in computing the company's taxable investment income (5 percent of net investment income but not over $25,000);

(6) Amounts paid or incurred where another person assumes liabilities under insurance and annuity contracts (except reinsurance ceded); and

(7) Generally all other deductions generally allowable in computing taxable income wtih certain modifications (the modifications are described in subsec. (e) below).

The modification provided in subsection (e) with respect to deductions otherwise generally allowable are as follows:

(1) No deduction allowed for interest on items on the life insurance and other reserves described in section 812 since additions to such reserves already are allowed under subsection (d)(2) described above;

(2) No deduction is allowed for reserves for bad debts although the deduction of actual bad debts is allowed;

(3) The charitable contribution deduction limitation of 50 percent is modified slightly to minimize complexity in the operation of this limitation;

(4) No amortizable premium deduction is allowed here (but is subsequently under sec. 817);

(5) The net operating loss deduction is not allowed since a new "operations loss deduction" (described in sec. 814) is allowed as a substitute;

(6) The deduction for partially tax-exempt interest is allowed only in the ratio of the normal tax rate (presently 30 percent) to the total tax rate (presently 52 percent); and

(7) In computing the deduction for dividends received, instead of limiting this deduction to 85 percent of taxable income it is limited to 85 percent of gains from operations computed without certain specified deductions.

Section 811(f) reduces the deductions otherwise allowed under this section in order to prevent a double allowance in the case of tax-exempt interest, partially tax-exempt interest, and the 85 percent of dividends excluded from income. Such amounts already have been accounted for since tax-exempt income is not includible in gross income and in the other two cases specific deductions are allowed under section 811(d). To allow other deductions, attributable to this income, also to be deducted under section 811(d) would result in a double allowance with respect to this income. To prevent this the regular deductions under this section are reduced by a ratio of the tax-exempt income, partially tax-exempt income, and the 85 percent of the dividends already deducted. This ratio is the proportion of the total net investment income (without the deductions for tax-exempt interest, dividends received, and small business) represented by the proportion of the investment income required to be added to the company's life insurance reserves under its reserve assumptions and the deduction for interest paid on supplementary contracts, etc.

As indicated previously, section 812 specifies the effect that increases or decreases in life insurance and certain other reserves are to have in computing gain or loss from operations. As indicated above, decreases in these reserves increase the gain from operations and increases in these reserves result in deductions in computing gain or loss from operations. This is indicated in subsections (a) and (b) of section 812.

Subsection (c) of section 812 defines what constitutes a reserve for purposes of this computation. In addition to the regular life insurance reserves required by law (but not including deficiency reserves) reserves for this purpose include unearned premiums and unpaid losses not included in life insurance reserves, amounts to satisfy obligations under insurance or annuity contracts (including supplementary contracts) where these obligations are not provided for under life insurance reserves, dividend accumulations and other amounts held at interest, and premiums received in advance, etc.

Section 812 (d) deals with effects on deductions (or amounts included in income) where there had been changes made in the method of computing the reserves. Paragraph (1) refers to what is generally described as reserve strengthening or weakening. This paragraph provides in the case of reserve strengthening that the additional deduction which would otherwise be allowable because of an addition

to the reserve occurring in this strengthening process is to be taken into account ratably over a 10-year period rather than in a single year. The paragraph also provides the reverse treatment in the case of reserve weakening.

Paragraph (2) of section 812(d) provides that except where under subchapter C, dealing with corporate reorganizations, certain carryovers of items are provided for, if in any year a company which previously was a life insurance company no longer qualifies, any adjustments remaining to be made will be taken into account in the prior taxable year.

Paragraph (3) of section 812(d) provides that an election to increase reserves for tax purposes, because computations are made on a preliminary term rather than a net level premiums basis, is not to be treated as a change in method of computing reserves and therefore that the deduction to be spread over the 10-year period where reserve strengthening or weakening occurs is not to include any amount attributable to this preliminary term election.

Section 813 defines dividends to policyholders, which as indicated in section 811 are deductible in determining gain or loss from operations. Subsection (a) of section 813 defines dividends to policyholders as dividends and similar distributions to policyholders in their capacity as such but excluding interest.

Section 813(b) takes account of the fact that policyholder dividends usually are initially set up on a reserve basis. This subsection also makes it clear that policyholder dividends to be deductible must be payable either during the taxable year with respect to which declared or during the following taxable year.

Paragraph (2) of subsection (b) provides that the deduction for policyholder dividends is not to result in a negative gain from operation after deducting taxable investment income. The effect of this is to require that these dividends be added back to gains from operation before determining any amounts which may reduce the taxable income base as otherwise determined.

Section 814 deals with the "operations loss deduction" which is similar to the net operating loss deduction available to ordinary corporations. Section 814(a) provides that the net operating loss deduction for a year consists of carryovers of operations losses from prior years and carrybacks of operations losses from subsequent years. Subsection (b) provides that the operations loss deduction, like the net operating loss deduction available to ordinary corporations, can be carried back 3 years (but not to a year before 1958) and then forward for 5 subsequent years.

Subsection (c) provides that the loss to be carried back or forward is to be the "adjusted loss" for any taxable year. This is the loss from operations as otherwise computed if the taxable investment income does not exceed $25,000. Where the taxable investment income exceeds $25,000 the adjusted loss from operations is the excess of the regular loss from operations over the taxable investment income reduced by $25,000. Generally limiting the adjusted loss to the excess of the regular loss from operations over a taxable investment income is necessary to reflect the fact that the loss from operations is first applied in reduction of taxable investment income and, therefore, to that extent is not available as a carryback or forward to another year. The allowance of the loss with respect to the first $25,000 of

taxable income, however, is necessary to reflect the fact that under section 802 losses from operations may be offset in full (instead of to the extent of 50 percent) against $25,000 of taxable investment income. The method of computing the operations loss deduction described in paragraph (2) of subsection (c) is similar to the method provided in the case of the ordinary net operating loss deduction.

D. Subpart D. Miscellaneous provisions

Subpart D contains certain miscellaneous provisions. There are three sections in this subpart; section 816, which is concerned with rules to be applied in determining gain or loss on the disposition of property; section 817, which is concerned with accounting provisions; and section 818, which is concerned with the tax treatment of foreign life insurance companies.

Section 816 provides that the basis for determining gain on a sale or other disposition of property held before January 1, 1958, is to be the fair market value of the property on that date if that is higher than the cost or other basis of the property. This rule applies only when the company in question has been a life insurance company at all times after January 1, 1958. Property for this purpose does not include insurance and annuity contracts or other inventory-type property. This new fair market value basis as of January 1, 1958, is provided because capital assets previously have not been taxable to life insurance companies. This rule gives comparable treatment, therefore, to the rule provided in 1913 when other types of property were initially subject to the income tax.

Subsection (b) is concerned with capital loss carryovers. This subsection provides that capital losses arising before 1955 are not to be treated as carryovers to 1958 or subsequent years. Losses arising in the period 1955 to 1957, inclusive, are to be available for carryovers to 1958 and subsequent years, only if the company carried on an accident and health, or other nonlife insurance business during that prior period, and then only in the ratio of the 1957 nonlife reserves to total reserves. These rules are provided because no capital gains or losses were recognized for life insurance companies before 1955, and in the period from 1955 to 1957, inclusive, they were recognized only to the extent attributed to accident and health or other nonlife insurance business.

Section 817 is concerned with accounting provisions. Subsection (a) provides that generally computations in determining life insurance company taxable income are to be made on an accrual basis and to the extent not inconsistent with other income tax provisions in the manner required in making the annual statement to the insurance commissioners.

Section 817(b) provides that premiums on bonds generally are to be amortized and discounts on bonds are to be accrued in accordance with the methods regularly used by the company, if its methods are reasonable. The amortization of premiums results in deductions and the accrual of discounts results in income.

Section 817(c) provides for certain adjustments which may be made for tax purposes in the computation of life insurance reserves where a company computes its reserves on a preliminary term basis. This subsection provides that an insurance company with reserves on this basis may elect to convert them to a net level premium basis for tax pur-

poses, but if it does so all preliminary term reserves must be so treated and that treatment must be adhered to for subsequent years unless the Secretary or his delegate approves a change. The reserves may be converted to a net level premium basis under any method approved by the Secretary or his delegate as reasonably approximating the result which would be obtained if an exact method were used.

Section 817(d) provides that no item may be deducted more than once in computing taxable investment income and in computing gain or loss from operations.

Section 818 deals with the tax treatment of foreign life insurance companies. Subsection (a) provides that a foreign life insurance company carrying on a life insurance business within the United States is to be taxable in the same manner as a domestic life insurance company if it would qualify under the definition of a life insurance company. Subsection (b) provides a special rule where the surplus of a foreign life insurance company which is held in the United States is less than a pro rata portion of its total surplus allocable to its United States business. In such a case the subsection provides that the policy and other contract liability deduction, for purposes of computing taxable investment income, is to be reduced by the portion of the surplus not held in the United States which is allocable to United States business, multiplied by the company's "deduction rate." Thus, such a company will not receive the policy and other contract liability deduction with respect to the portions of its surplus allocable to United States business which is held outside of the United States since the assets represented by this surplus are not included in the net investment income on which United States tax is computed.

E. Technical amendments and effective date

Section 3 of the bill contains certain technical amendments required outside of part I of subchapter L which relates to life insurance companies. Technical amendments are required in the case of section 841, dealing with credits for foreign taxes; section 381, dealing with carryovers and certain corporate reorganizations; section 1016(a), relating to rules in adjusting the basis of property; section 1232(a)(2)(C), relating to bonds and other evidences of indebtedness, and other conforming changes required in cross-references.

Section 4 of the bill provides that this bill is to apply to taxable years beginning after December 31, 1957.

×